you have a proposed rate, a flat rate of $6.86, how does that compare to what BellSouth would charge for that?

A Again, under the staff -- and by the way, my usage -- the usage assumptions I used I've been able to look at a little bit, they're very close to what the staff used. So there's no issue being introduced by different usage assumptions. On average staff rates produce a rate of $4.18. We're proposing a flat rate, it's fixed, give them the money of $6.86, BellSouth would want for that same usage level $11.18. So in effect we're proposing TELRIC plus $2.88, which is the 65 percent increase and BellSouth would be almost, you know, over $11 to -- for something that is used along with a loop to serve basic residential and business customers.

Q And that rate you mentioned TELRIC plus, how much?

A $2.88 is the premium above Bell -- above the staff's calculation of TELRIC.

Q Okay, and when we looked yesterday at the Exhibit CompSouth 1 --

A I'm sorry, $2.78, yeah.

Q Okay, and when we looked a the Exhibit CompSouth 1, which we reproduced the last page of, the confidential page here --

A Yes.

Q -- how does that compare, you say the CompSouth's

proposal is TELRIC plus $2.86.

A On that $2.78.

Q $2.78, and how does that compare with this -- with the standard, the S category, standard rate that's in most of those commercial agreements?

A Well, it'd be TELRIC plus $7.00.

Q Okay, and then are there any that are different?

A Yes, there were five carriers that negotiated -- negotiated rates.

Q And those are reflected in this attachment from CompSouth 1?

A Yes, and I won't give any of the numbers, but you'll see that for four of them the ending rate is not significantly different then TELRIC plus $7.00. But there's one carrier, carrier 12 that is if -- if that chart is accurate and it's BellSouth's chart and their witness testified yesterday that it's accurate, our proposal in this docket is significantly higher than the rate that they voluntarily have provided to carrier 12.

Q And Ms. Foshee also talked to you a bit about carriers' motivations for signing commercial agreements, do you remember that?

A Yes.

Q And I'd ask you to look at the other document that I've handed out, which is ITC^DeltaCom Communications Inc.

response to BellSouth Telecommunication Inc. first set of discovery requests in this proceeding, do you have a copy of that?

A No.

Q Wow, I think everyone else does. Okay.

A Thank you.

Q And we just reproduced one of the pages of the response attachment A concerning ITC^DeltaCom's residential local service offering. Could you explain to us what your examination of this discovery response indicated about at least one carrier, ITC^DeltaCom's, history with its commercial agreement?

A Yeah, ITC^DeltaCom signed a commercial agreement. As it was getting ready to negotiate -- as it was negotiating that commercial agreement, which I think they signed in April of '05, it started out the year offering residential service, with the service described here with all these features and calling bundled in it around, of around $35 a month. As they were negotiating and realized the type of prices that BellSouth was requiring, they increased it by $5.00 a month. Now, they signed the agreement and -- but that doesn't mean -- this is a perfect illustration of of carriers signing an agreement, but not because they believe that the agreement is sustainable or gives a competitive opportunity at all. They sign it. They

raise the rate now up to $50 a month. So, it's had an increase of $15 a month and then that just takes them into the November time frame when they abandoned the residential market entirely -- entirely and withdraw.

And while this is one carrier, I think when you look at the pattern of the -- of the competitive lines under the so-called commercial agreements, they're not commercial and they're not agreements, they are people who have one provider in the marketplace, BellSouth, put in an environment where they can't handle moves, adds, changes, whatever without having some sort of agreement with BellSouth. But this interrogatory response illustrates quite well that you can't conclude from the fact that someone signed an agreement with the idea that somehow the rates in that were considered reasonable. They're reasonable, if what you want to do is get out of the market in six months -- well, they're not even reasonable then. But, you know, that's all it showed, is that they needed a bridging amendment to get them out of the market and the way they wanted to access. And that -- obviously 271 is not about transitioning carriers to a smoother market, access market abandonment.

Q Now, Ms. Foshee referenced -- I think she kept saying eight CompSouth members had commercial agreements, I guess, if you delete AT&T and MCI from that list, that would

be six according to her representation, right?

A I have no idea, she's never -- she never used the names of the carriers. I think she had already deleted AT&T and MCI ahead of time.

Q Okay.

A But, you know, this is about loops, transports and switching. It isn't only about switching. Switching people had dire consequences earlier than loops and transports, but the pricing issue and the pricing testimony is -- is about all three elements.

Q And to you knowledge are there members of CompSouth who are actively in the market trying to provide services that use DS1 loops and the DS1 and DS3 transport?

A Absolutely, I mean, for -- for carriers that are using their own switches ia a practical matter, that's the primary market that they're trying to address. Carriers, not traditional phone customers, but customers that have reached a point where they want a digital high speed connection for voice and data combined. And the way you connect to those customers are DS1s. So, what those -- the prices those carriers face for DS1 are a fundamental input to their business and whether or not they can continue to serve medium sized business customers in Georgia.

Q And do you typically experience any problems getting input from such clients as you prepared testimony

for CompSouth?

A I've never had client input problems in the sense that they were shy. Mr. Watkins is, after all, one of my clients.

Q Exhibit A. On those loops and transport rates, there was discussion with Ms. Foshee concerning special access and the use of special access instead of UNEs. The paragraph 664, the "might" paragraph that we talked a whole lot about, that was in the TRO, right?

A That's correct.

Q Issued in 2003, thereabouts?

A Okay, I'll accept that subject to check, yeah.

Q And then you discussed some analysis the FCC did with the hideous irony analysis you talked about, was that in the TRO or the TRRO?

A That was in the TRRO at the end of the follow-up proceeding of the TRRO. So, that would have been the FCC's first time that it actually even looked at whether special access might be usable for local exchange services. Now, admittedly they did do it for a different purpose, they did it for impairment instead of looking to see whether or not there was enough competition for pricing. But they did look at those special access prices in more detail for the question that's really relevant here, and that is, is that any evidence that these price levels can support

competition? And they concluded that there isn't. I think when you look at those, you know, $50 going to $179.00, that's a dramatic change in a carrier's cost structure.

Q And just -- just on this matter, just to be sure it's clear for the record, the -- the impairment test for loop and transport in the TRRO, I think you referenced they are based on proxy tests. And what -- what in your mind, I guess, what I'm trying to get is, what is the difference between the FCC saying there's plenty of competition there therefore there's no impairment versus what they did in using those test?

A I'll give the clearest example, I think in Atlanta there's a down -- there's a wire center in downtown Atlanta where the application of these criteria mean that DS1 loops aren't going to be available to serve any of the businesses served by that wire center under 251, you know, the way the these criteria apply. What did the Commission look at, and I mean, you look at this because this is what the FCC test required you to look at. You looked at, how many business lines are served by that wire center. How big is this area in downtown Atlanta, how many lines are there? And then you look to see how many carriers have actually collocated in the wire center, the building that the loops run out to, all right. There's no information there at all that tells you whether there's a single other way to reach those customers

than to buy loops from BellSouth. Because nowhere in that test do you actually answer the question hey, in this downtown area there's all these customers, carriers are today serving those customer, buying loops from BellSouth to reach them, can they go buy loops from somebody else. You don't look at that at all. And it's a bad -- it's my opinion it's a bad proxy, but that's what the FCC set up. So, all you did is you decided or applying the FCC criteria you conclude yes, there's a lot of business lines in this wire center, which you would expect, since there are a large number of CLEC that have collocated there to buy the loops. But now because of that criteria you're going to take away their ability to reach all those customers under 251. And if BellSouth had their way you would replace it with hey, you've got to pay $179.00 now to reach all these customers instead of what we're proposing of $86.00.

Nowhere in that analysis that the FCC or that the Commission did, did anyone ever look out the window and say is there any other way to reach these customers other than BellSouth's loops? Is there a single other carrier that has any loops that go out to these businesses. And as a practical matter there's very, very -- it's very unusual to be able to find another carrier that has built facilities in the individual buildings that you can go buy loops from. That's -- for better or for worse, mostly worse, that's what

FCC criteria called for, but, the backstop -- the competitive backstop -- the competitive protection is all right, you still get to pay just and reasonable 271 rates.

Q And just one final thing, to -- I want to discuss some of the questions that were raised about your methodology for establishing just and reasonable rates. Ms. Forshee noted that there were -- that you had proposed different rate levels as to switching in an FCC proceeding and then in this proceeding. And what additional information was available to you in this case that supported the methodology you're supporting here?

A I used the BellSouth cost studies that their witnesses identified as their belief at capturing their total forward looking costs. That information was not available in the other -- the other times that a rate proposal had to be made.

It's -- quite frankly, it just keeps showing why the state should do rate settings, the FCC is not good at setting rates, because the parties don't have an opportunity to collect the information.

Q And that -- that approach based on using forward looking costs, you think is appropriate?

A I think it still overstates what BellSouth should be getting for these facilities. But as I indicated yesterday as candidly as I felt comfortable, we recognize

that BellSouth wants to appeal this and we wanted to take away as many appeal points as we possibly could take. And I don't see how they're going to go to a judge and tell the judge that somebody using their cost studies and then giving them more money then they had asked for somehow is producing rates that's unreasonable. They're not going to get there with that.

Q How does the methodology that you propose compare to what's called the new services methodology?

A It is basically the new services methodology. It is a direct cost, plus reasonable contribution, the common cost and overhead methodology. It's what the FCC calls the new services test.

MR. MAGNESS: Okay, that's all I have. Thank you. I would like to offer into evidence, I believe it's going to be CompSouth 4, the ITC^DeltaCom response to BellSouth's discovery request, the excerpt that we used in cross examination.

CHAIRMAN WISE: So entered.

(The document referred to was marked for identification as CompSouth Exhibit Number 4 and received in evidence.)

MR. MAGNESS: In addition, we'd ask that the information that we handed out, the summary sheets just be

included as a demonstrative exhibit.

CHAIRMAN WISE: As an exhibit?

MR. MAGNESS: Yes, we can call it CompSouth 5.

CHAIRMAN WISE: Okay.

MR. MAGNESS: Or illustrative, I'm sorry, not demonstrative.

CHAIRMAN WISE: Marked and entered.

(The document referred to was marked for identification as CompSouth Exhibit Number 5 and received in evidence.)

MR. MAGNESS: CompSouth 5, and finally, we would ask that Mr. Gillian's testimony be moved into the record.

CHAIRMAN WISE: Will do.

(Whereupon, the prefiled testimony of Mr. Gillan follows:)

BEFORE THE
GEORGIA PUBLIC SERVICE COMMISSION

In the Matter of: Generic Proceeding to Examine Issues Related to BellSouth's Obligation to Provide Unbundled Network Elements	))))	Docket No. 19341-U Phase II February 10, 2006

Testimony of Joseph Gillan
On Behalf of
The Competitive Carriers of the South, Inc.

I. Introduction

Q. Please state your name, business address and party sponsoring your testimony.

A. My name is Joseph Gillan. My business address is P. O. Box 541038, Orlando, Florida 32854. I am testifying on behalf of Competitive Carriers of the South, Inc. ("CompSouth"). CompSouth is the industry association representing

competitive carriers operating in the region where BellSouth is the incumbent Bell Operating Company.

Q. What is the purpose of your testimony in this phase of the proceeding?

A. The purpose of this phase of the proceeding is to establish just and reasonable rates for those network elements required to be offered under Section 271 of the Act, but which are no longer required to be offered under Section 251 of the Act at TELRIC-based rates.[1] The purpose of my testimony is to recommend specific prices for (a) high capacity local loops, (b) high capacity transport, and (c) local switching that comply with the "just and reasonable" rate standard adopted by the FCC. If the Commission adopts my recommendations, BellSouth would receive *higher* prices for its Section 271 offerings than existing UNE rates, but not so *much* higher as to exceed the "basic just, reasonable, and nondiscriminatory rate standard … that has historically been applied under most federal and state statutes [thereby violating] … Congress's intent that Bell companies provide meaningful access to network elements" so as to foster local competition.[2]

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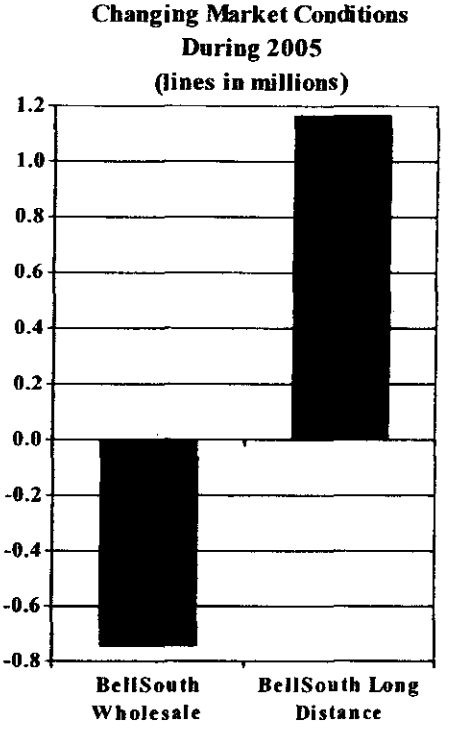
[1] *Order Initiating Hearings to Set a Just and Reasonable Rate Under Section 271*, Docket No. 19341-U, January 20, 2006.

[2] In the Matter of Review of §251 Unbundling Obligations of Incumbent Local Exchange Carriers, CC Docket No. 01-338, Implementation of the Local Competition Provisions of the Telecommunications Act of 1996, CC Docket No. 96-98, Deployment of Wireline Services Offering Advanced Telecommunications Capability, CC Docket No. 98-147, Report and Order and Order on Remand and Further Notice of Proposed Rulemaking (rel. August 21, 2003) ("*TRO*"). ¶ 663 (footnotes omitted).

Q. How is your testimony organized?

A. My testimony is organized as follows. First, the testimony addresses the "just and reasonable" pricing guidance provided by the Federal Communications Commission for Section 271 offerings. Second, the testimony recommends specific just and reasonable prices for loops, transport and local switching, which are the elements at issue in this proceeding. Finally, I address what I expect to be the principal claims by BellSouth that (a) the *switching* rates in its so-called "commercial agreements" are presumptively just and reasonable merely because such agreements exist, and (b) that the *loop and transport* offerings in its interstate special access tariff satisfy its Section 271 obligations. Neither argument excuses BellSouth from charging rates that provide competitors meaningful access to foster the local competition demanded Congress as the *quid quo pro* for BellSouth's authority to provide long distance services.[3] There is little question that this Commission stands at a



[3] BellSouth's penetration of the consumer and small business market is approximately 60%, providing it nearly $1.4 billion in revenues last year. BellSouth's dominance of this market is reflected in market conditions that BellSouth euphemistically describes as "pricing discipline

crossroads: either it will give Section 271 practical effect by arbitrating just and reasonable rates for Section 271 network elements, or it can stand by and watch local competition collapse as BellSouth asserts in dominance in the long distance market. Clearly, by initiating this proceeding, the Commission has chosen to ensure that Georgia consumers and business benefit from a robust local environment.

II. The Just and Reasonable Rate Standard

Q. Is there any question that BellSouth remains obligated to offer loops, transport and switching under Section 271 of the Act, even where the FCC has determined that BellSouth may not have the same obligation under Section 251?

A. No. There is no question that BellSouth's obligation under §271 is both separate from, and additional to, whatever obligation BellSouth may (or may not) have to offer network elements under §251 of the Act. As the FCC explained in the *Triennial Review Order* (*TRO*):

> ... the plain language and the structure of section 271(c)(2)(B) [i.e., the competitive checklist] establish that BOCs have an independent and ongoing access obligation under section 271.... Checklist items 4, 5, 6, and 10 separately impose access requirements regarding loop, transport, switching, and signaling,

and stable churn" (i.e., its prices are holding steady and it seeing less competition). BellSouth Investor News, January 25, 2006, page 8.

> without mentioning section 251. Had Congress intended to have these later checklist items subject to section 251, it would have explicitly done so as it did in checklist item 2. Moreover, were we to conclude otherwise, we would necessarily render checklist items 4, 5, 6, and 10 entirely redundant and duplicative of checklist item 2 and thus violate one of the enduring tenets of statutory construction: to give effect, if possible, to every clause and word of a statute.[4]

The FCC's conclusions regarding the additional obligations of §271 were affirmed by the D.C. Circuit in *USTA II.*[5] BellSouth's obligation to continue to offer access to listed checklist elements – switching, loops, transport and signaling – under §271 continue, unless and until the FCC "forebears" from the requirements of the competitive checklist.[6]

Q. If BellSouth must continue to "offer" the listed checklist items, then what is the principal issue that must be resolved?

A. The principal – indeed, the controlling – issue is one of price.[7] While network elements required under Section 251 must be strictly priced at TELRIC, elements

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[4] *TRO* ¶ 654 (footnotes omitted, emphasis added).

[5] *USTA v. FCC*, 359 F.3d 554, 588-590 (D.C. Cir. 2004) ("*USTA II*").

[6] *In the Matter of Petition for Forbearance of the Verizon Telephone Companies Pursuant to 47 U.S.C. § 160(c),* WC Docket 01-338 *et al.*, Memorandum Opinion and Order at ¶ 7 (rel. Oct. 27, 2004) ("*Broadband Forbearance Order*").

[7] As the Commission is aware, there is a separate issue concerning whether BellSouth is obligated to "commingle" network elements offered to comply with Section 271 with network elements offered to comply with Section 251 of the Act. Because most Section 271 configurations will also involve a Section 251 loop (either as part of an EEL or with switching), there is little question that the only way for BellSouth to provide "meaningful access" (as required by the FCC) is for it to support Section 271 elements in commingled configurations with

required under Section 271 must be priced according to a potentially more liberal "just and reasonable" pricing standard. As the FCC explained:

> Thus, the pricing of checklist network elements that do not satisfy the unbundling standards in section 251(d)(2) are reviewed utilizing the basic just, reasonable, and nondiscriminatory rate standard of sections 201 and 202 that is fundamental to common carrier regulation that has historically been applied under most federal and state statutes, including (for interstate services) the Communications Act. Application of the just and reasonable and nondiscriminatory pricing standard of sections 201 and 202 advances Congress's intent that Bell companies provide meaningful access to network elements.[8]

The core pricing standard provided by the FCC is that Section 271 network element prices should comply with "the basic just, reasonable, and nondiscriminatory rate standard ... that has historically been applied" (by both the FCC and the states), with the goal that competitors should be provided the "meaningful access" to local facilities that Congress intended.

Section 251 elements. That issue was decided by the Commission is the initial phase of this proceeding and I do not address it in detail here. Separate and apart from the issue as to whether BellSouth has an *affirmative* obligation to connect elements (that are not yet connected), however, is the issue as whether BellSouth has any authority to *disconnect* (less politely, sabotage) network components that are already connected. In many instances, the network connections used by a CLEC to serve its customers are already connected and any inference that BellSouth has the authority to disrupt such connections is deliberately anticompetitive. There simply is no legitimate purpose served by BellSouth instructing technicians to disconnect network facilities so that competitors are forced to resurrect those same connections in more costly ways. Importantly, the Supreme Court has already ruled that such a practice is anticompetitive (*AT&T v. Iowa Util. Bd,* 525 U.S. 366, 394 (1999). Although the Supreme Court's finding was in the context of BellSouth's nondiscrimination obligations with respect to Section 251 network elements, it is absurd to suggest that Congress would sanction (under Section 271) activities that the Supreme Court has recognized are intended "not for any productive reason, but just to impose wasteful reconnection costs on new entrants."

[8] *TRO* ¶ 663 (footnotes omitted).

As I explain below, the "just and reasonable" rate standard has traditionally required a reasonable nexus between cost and price, even though, over the years, different approaches to cost have been used. In the context of Section 271 network elements, however, BellSouth claims that "just and reasonable" now means that rates should be set "at what the market will bear,"[9] without any regard to cost (or, for that matter, market) conditions.

Q. Why does BellSouth claim that Section 271 network elements may be priced "at what the market will bear?"

A. Fundamentally, BellSouth claims that the FCC created a limiting "just and reasonable" standard unique to Section 271 elements in ¶664 of the *TRO*.[10] I address all of the reasons why BellSouth's reading of this paragraph is flawed later in the final section of my testimony.[11] My focus here, however, is to emphasize that the FCC was unambiguously clear that it was adopting the "basic

[9] BellSouth Telecommunications Inc.'s Response in Opposition to Competitive Carriers of the South Inc.'s Emergency Motion to Compel Discovery Responses, Docket 19341-U, February 6, 2006, page 3.

[10] *TRO* ¶ 664 states (emphasis added):

> We note, however, that for a given purchasing carrier, a BOC might satisfy this standard by demonstrating that the rate for a section 271 network element is at or below the rate at which the BOC offers comparable functions to similarly situated purchasing carriers under its interstate access tariff, to the extent such analogues exist. Alternatively, a BOC might demonstrate that the rate at which it offers a section 271 network element is reasonable by showing that it has entered into arms-length agreements with other, similarly situated purchasing carriers to provide the element at that rate

[11] *See* Section IV.

just, reasonable, and nondiscriminatory rate standard … that has historically been applied" to all manner of services.[12] Consequently, it is appropriate to first consider how the basic standard has been used in the past, before addressing the guidance provided by ¶664.

A. The Evolution of the Just and Reasonable Rate Standard

Q. What do you believe the FCC was referring to with its direction that Section 271 rates should comply with the "basic just, reasonable, and nondiscriminatory rate standard … that has historically been applied?"

A. As the Commission is aware, the "just and reasonable" rate standard is a foundation of traditional regulation, whether that regulation is outlined in federal or state statute. The concept is not limited to telecommunications, but is generally applied to all regulated utilities. The touchstone to judging just and reasonableness has commonly been cost. As the FCC has explained:

> The Communications Act requires that rates be just and reasonable and not create unreasonable discrimination or undue preference. Sections 201(b) and 202(a), 47 U.S.C. §§ 201(b), 202(a). Costs are traditionally and naturally a benchmark for evaluating the reasonableness of rates, because cost-based rates both deliver price signals which contribute to efficient use of the networks and

[12] *TRO*, ¶ 663.

> generally distribute network costs to the customer who causes those costs."[13]

Over time, as FCC regulation has adapted to changing conditions, its underlying commitment that rates should bear a reasonable nexus to cost has not changed. For instance, when the FCC adopted price cap regulation, it made clear that specifically designed its price cap system to reflect costs:

> We proposed to adjust price caps each year according to a predetermined formula that is designed to ensure a continuing nexus between tariffed rates and the underlying cost of providing service.
>
> ***
>
> A carrier's services are grouped together in accordance with common characteristics, and the weighted prices in each group are adjusted annually pursuant to formulas designed to ensure that rates are based on cost ...
>
> ***
>
> ... the foundation of the price cap regulatory approach is to ensure that rates follow costs, while creating incentives to reduce costs...[14]

The notion that cost should be the principal touchstone to judge the reasonableness of rates permeates the record of FCC decisions, including those decisions that granted temporary deviations from cost.[15] The long standing

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[13] *Memorandum Opinion and Order, Investigation of Special Access Tariffs of Local Exchange Carriers*, CC Docket 85-166, Adopted October 13, 1988, Released December 1, 1988, 4 FCC Rcd. No. 12, ¶ 32, emphasis added.

[14] *Report and Order and Second Further Notice of Proposed Rulemaking*, Federal Communications Commission, CC Docket No. 87-313, April 17, 1989, ¶¶'s 8, 38 and 865. Emphasis Added.

[15] For instance, the FCC once permitted the RBOCs to strategically price special access services, due to the "dislocations" of the AT&T divestiture and the fear of bypass from high

importance of "cost" to the just and reasonable rate standard remained, even as historical (sometimes called embedded) cost measures began to be replaced by more prospective (i.e., forward-looking measures) of cost. As the Supreme Court noted in reviewing the history of regulated ratemaking in *Verizon*:

> What had changed throughout the era beginning with *Smyth* v. *Ames* was prevailing opinion on how to calculate the most useful rate base, with disagreement between fair-value and cost advocates turning on whether invested capital was the key to the right balance between investors and ratepayers, and the price cap scheme simple being a rate-based offset to the utilities' advantage of superior knowledge of the facts employed in cost-of-service ratemaking. What is remarkable about this evolution of just and reasonable ratesetting, however, is what did not change. The enduring feature of ratesetting from *Smyth* v. *Ames* to the institution of price caps was the idea that calculating a rate base and then allowing a fair rate of return on it was a sensible way to identify a range of rates that would be just and reasonable to investors and ratepayers. [16]

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initial access rates. Even then, however, the FCC's approach was to "bracket" allowed pricing relationships in an effort to reflect costs:

> As the Commission found in the *Strategic Pricing Order*, the six to one ratio represents the most likely approximation of the cost relationship between HiCap and VG services based on the record. The 4 to 8 range should be broad enough to encompass a "cost based" rate that might be produced by any rational cost allocation methodology used by an exchange carrier in the near future.

Order on Reconsideration, Investigation of Special Access Tariffs of Local Exchange Carriers, CC Docket 85-166, Adopted November 28, 1989, Released January 19, 1990, 5 FCC Rcd. No. 2, ¶ 73.

[16] *Verizon* at 481. Notably, although the Supreme Court recognized that the Telecommunications Act of 1996 was structured to move away from traditional historical cost based measures of regulation, that movement was not towards pricing services requested by competitors "at what the market would bear." To the contrary, the Supreme Court recognized that (at least with respect to Section 251), the Act adopted a rate standard "...designed to give aspiring competitors every possible incentive to enter local retail telephone markets, short of confiscating the incumbent's property."

Q. How have costs traditionally been measured when establishing just and reasonable rates?

A. Traditionally, costs were measured using "accounting" costs, sometimes called historical or embedded costs.[17] Under such a methodology, the actual book costs incurred by the incumbent would be assigned or allocated to its services through a "fully distributed costing" approach. Fully distributed costing, however, relies extensively on allocation methods because many of the firm's costs cannot be directly attributed to a particular service. For this (and other reasons), the regulatory trend has been to move away from using fully distributed historical costs, in favor of more efficient cost-based approaches.

For instance, in developing its *Open Network Architecture* policies (a form of unbundling predating the 1996 Act),[18] the FCC replaced the fully distributed

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[17] For instance, as recently as the *TRRO*, the FCC noted (¶51): "Special access prices are regulated pursuant to the Communications Act's "just and reasonable" standard, which predates and bears no necessary relation to this cost-based standard, relying instead on historical costs."

[18] As the FCC explained:

> ONA was designed to unbundle certain services provided by BOCs, both to promote efficient and innovative use of the network by independent enhanced service providers (ESPs) and to prevent discrimination by BOCs in their offerings of BSEs to competing ESPs and BOC-owned ESPs. The Commission concluded that the provision of unbundled basic service "building blocks" would promote the ability of the BOCs' ESP competitors to compete effectively. Hence, the Commission ordered the BOCs to unbundle from their existing feature group access arrangements optional features called BSEs.

Order, Federal Communications Commission CC Docket 92-91, December 2, 1993, Released December 15, 1993, ¶ 4 (footnotes omitted) (*ONA Tariff Order*).

costing approach with a more flexible "direct cost plus reasonable allocation" standard that did not require the incumbent to fully assign all costs to all services. The FCC described the approach as follows:

> In the Part 69/ONA Order the Commission ... replaced the traditional FDC price ceiling with a more flexible cost-based test. The new test retained the "direct cost" component of the traditional approach but afforded the LECs greater leeway in the application of overhead loadings.[19]
>
> ***
>
> Once the direct costs have been identified, LECs will add an appropriate level of overhead costs to derive the overall price of the new service. To provide the flexibility needed to achieve efficient pricing, we are not mandating uniform loading, but BOCS will be expected to justify the loading methodology they select as well as any deviations from it.[20]

As recently as 2002, in its evaluation of ILEC charges to competitive payphone providers, the FCC summarized its general pricing guidelines making clear that they were based on a "direct cost plus just and reasonable allocation of overhead" approach:

> The *Bureau Order* summarized the guidelines to be applied under *Computer III* and other Commission proceedings concerning the application of the new services test and cost-based ratemaking principles to services that incumbent LECs offer to competitors. The Bureau explained that, to satisfy these requirements, an incumbent LEC must demonstrate that the proposed payphone line

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[19] *Memorandum Opinion and Order on Reconsideration and Third Further Notice of Proposed Rulemaking*, Federal Communications Commission CC Docket 87-266, October 20, 1994, Released November 7, 1994, 10 FCC Rcd 244, ¶ 212 ("*Video Dialtone Reconsideration*").

[20] Id., referencing *Amendments of Part 69 of the Commission's Rules Relating to the Creation of Access Charge Subelements for Open Network Architecture, 6 FCC Rcd 4524 at 4531 (1991).* The ILECs were also permitted to seek a higher rate of return, or "risk premium," for new services that they deem especially risky.

> rates do not recover more than the direct costs of the service, plus "a just and reasonable portion of the carrier's overhead costs."[21]

Q. Does the FCC favor the use of prospective (i.e., forward-looking costs) as the basis of setting rates?

A. Yes. When reviewing the RBOCs initial *Open Network Architecture* tariffs for unbundled basic service elements, the FCC specifically concluded that forward looking costs were appropriate.

> The Part 69 ONA Order specifies that rates for BSEs must be cost supported under the new service standard for price cap filings. We conclude that, for purposes of this proceeding, prospective costs are the economically relevant costs to use to support BSE rates, because they represent the costs a profit maximizing firm would consider in making a business decision to provide a new service. Historical costs associated with plant already in place are essentially irrelevant to the decision to enter a market since these costs are "sunk" and unavoidable and are unaffected by a new product decision. We also believe that use of prospective costs for new BSEs is in the public interest, because the resulting generally lower BSE prices will encourage innovative services.

Even as the FCC moved from a historical cost-basis, to an analysis based on prospective technologies and forward-looking rates, it remained committed to ensuring that rates remained reasonable in relation to their underlying costs. As the FCC explained (in that same *ONA Tariff Order*):

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[21] *Memorandum Opinion and Order*, Federal Communications Commission FCC-025, January 28, 2002, Released January 31, 2002 (*Payphone Order*), ¶ 212 (footnotes omitted, emphasis added).

> As to the BOCs' assertion that any revision to their rates would conflict with the Part 69 ONA Order, the "flexible cost-based approach" described in the Part 69 ONA Order was intended to give carriers flexibility sufficient to encourage efficiency and innovation, not complete freedom in developing rates.
>
> > Once the direct costs have been identified, LECs will add an appropriate level of overhead costs to derive the overall price of the new service. To provide the flexibility needed to achieve efficient pricing, we are not mandating uniform loading, but BOCs will be expected to justify the loading methodology they select as well as any deviations from it.
>
> The Commission's intent was to permit carriers to establish a reasonable and consistent method for their identification of direct costs, with the flexibility needed for efficient pricing to be achieved in the administrative loadings applied to the direct cost figures. Thus, limiting carriers' ratemaking discretion, as we do in this Order below, is entirely consistent with our intent in the Part 69 ONA Order. None of these limitations on ratemaking flexibility noticeably reduce the incentives we established in the Part 69 ONA Order for development of innovative new services and efficient prices.[22]

As the above summary demonstrates, the "just and reasonable" rate standard has remained a *cost*-based standard, even as it has evolved through price caps and other policies. The FCC did not grant BellSouth carte blanche to price at "what the market will bear" for its Section 271 obligations; the rates for these offerings must remain "just and reasonable" and provide competitors the "meaningful access" that Congress intended.

[22] *ONA Tariff Order*, ¶12. (Footnotes omitted).